FOMC Review: Maintains its framework and makes a small technical adjustment

- The FOMC maintained status quo on policy rates but raised its interest on Excess Reserves (IOER) by 5 bps on expected lines to 1.6%
- The adjustment on IOER was purely technical not a reflection of Fed’s monetary policy stance. The hike in IOER was done to raise the effective fed funds rate towards central band of the target fed funds range of 1.5%-1.75%
- It also maintained its open market purchases of USD 60 bn in treasury bills up to at least Q22020 and the Fed Chair in the press conference provided some guidance on balance sheet strategy
- The main message was that the central bank will strive to ensure that money market operates smoothly
- However, the messaging had a dovish underpinning that was visible in the change in its guidance that was provided on inflation
- Risks to the outlook might have diminished from reducing trade-war intensity but there was some acknowledgement of the growing risks from the impact of ‘Coronavirus’
- On balance, we maintain our call of the FOMC keeping rates on hold over 2020 with a bias towards ensuring policy remains accommodative
- Market response to the policy meeting was limited as both US Treasury yields and the DXY are being influenced by risk aversion on the back of concerns about the ‘Coronavirus’

On expected lines

The FOMC maintained status quo on policy rates and its balance sheet strategy that was on expected lines. While there was the annual rotation of voting members that takes place in the new year, the decision was unanimous. The change in the composition did not have a substantial effect in terms of the messaging, policy statement and guidance that was provided. There was a small technical adjustment that was made as the interest on excess reserves (IOER) was raised by 5 bps to 1.60% on expected lines. However, there were some subtle changes in communications that was provided that suggest that the FOMC is committed to keeping policy accommodative.

- **Stronger inflation guidance:** While the policy statement was relatively unchanged, there was one important tweak that was made. The most notable change was the wording around inflation. The statement emphasized that ‘policy will remain appropriate…until inflation returns to the FOMC’s symmetric 2% objective’ rather than ‘near the committee’s symmetric 2% objective’. This subtle change was made to tighten the Fed’s messaging on inflation. The FOMC Chair clarified in the press conference that members of the FOMC felt that the change was required to communicate that it is not comfortable with inflation hovering below the 2% mark. **We view this change as dovish as it implies that policy will remain accommodative until inflation trends higher towards the target level.**

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January 30th, 2020

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Outlook on the economy kept relatively unchanged: The only other change in the policy statement was that household spending was described as ‘growing at a moderate pace’ rather than a ‘strong pace’ as was indicated in the previous policy statement. Otherwise, the description in the labour market was kept unchanged as was the assessment on other aspects of the economy. The outlook on the economy was still considered to be constructive.

Risks to the outlook: The policy statement indicated that the FOMC will continue to monitor ‘global developments’ as ‘it assesses the appropriate path of the target range of the fed funds rate’. In this regard, the FOMC Chairman emphasized that ‘uncertainties have diminished’ given recent trade developments but not disappeared with ‘coronavirus’ emerging as a new risk factor. However, the Fed Chair stated that it was too early to judge the medium-term impact of the new strain of virus. The FOMC Chair continued to stress that investment spending remains weak and that the uncertainty about the outlook has not gone away for most businesses as yet.

Technical adjustment: IOER hiked: On expected lines, the FOMC raised the IOER by 5 bps to 1.60%. As we emphasized in the previous research notes, this was done to take into account the fact that the effective fed funds rate was moving towards the lower-end of the target rate set. An important point to keep in mind is that the Fed’s main target variable is the effective fed funds rate, which is the rate at which banks lend to each other in the inter-bank market. Hence, the Fed guides overnight lending rate within the banking system by setting the target range and adjusts its balance sheet policy to ensure that the effective rate trades within the range. The FOMC had embarked on increasing the size of its balance sheet by conducting OMO operations to the tune of USD 60 bn per month from October-2019 onwards. The net result has been an improvement in the overall liquidity conditions that has been pushing the effective fed funds rate lower. However, by raising the rate at which banks park excess reserves with the Fed, the IOER, it should in theory work to push the effective fed funds rate higher within the central area of the target range set of 1.5%-1.75%. The FOMC Chairman was also quick to emphasize that the technical adjustment was not a reflection of any changes to monetary policy or the monetary policy framework but to ensure that money market operations are not distorted.

More clarity on balance sheet strategy: The majority of the Fed Chair’s press conference was spent on clarifying the Fed’s stance on its balance sheet. The Fed Chair emphasized that it will continue with its open market operations till at least the Q22020 and that more repo market operations will be used. The idea of using the OMOs was to stabilize the balance sheet decline that had set in post the quantitative tightening episode over 2017-H12019. Going forward, we suspect that the Fed could gradually taper the pace of treasury bill purchases over the year but will ensure that the excess reserves remains at least at USD 1.5 tn. The underlying message is that the Fed will ensure that its balance sheet does not shrink sharply and liquidity remains comfortable.

The road ahead

On balance, the policy statement and press conference came in line with our expectations. We interpret the messaging to be on the dovish side with the FOMC and its Chairman clarifying the need to keep policy accommodative. Hence, we stick with our base-case scenario of the FOMC maintaining status quo over 2020 with a bias towards continuing to support the economy. The fed funds futures market is pricing in ~86% probability of a 25 bps rate cut by end-December-2020 that is much higher than the ~50% probability about a fortnight back. However, much of the increase in pricing relates to concerns about Coronavirus.

Market impact: Risk aversion to remain dominant

From market’s perspective, there was very little to draw on from this policy meeting. In theory, the dovish guidance should have been risk positive. However, concerns about the spread of Coronavirus is working to drive price action resulting in persistent risk aversion in the market. The main concern for investors would be the degree to which the virus spreads globally as it could then depress global growth significantly and not just be confined to China and EM Asia. US Treasury yields have moved sharply lower and the DXY has traded higher. We expect this trend to remain intact in Q12020.
<table>
<thead>
<tr>
<th>Growth</th>
<th>The labor market remains strong and that economic activity is rising at a moderate rate.</th>
<th>The labor market remains strong and that economic activity is rising at a moderate rate.</th>
<th>Neutral</th>
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<tbody>
<tr>
<td>Labour market</td>
<td>Job gains have been solid, on average, in recent months, and the unemployment rate has remained low.</td>
<td>Job gains have been solid, on average, in recent months, and the unemployment rate has remained low.</td>
<td>Neutral</td>
</tr>
<tr>
<td>Other sectors</td>
<td>Although household spending has been rising at a strong pace, business fixed investment and exports remain weak</td>
<td>Although household spending has been rising at a moderate pace, business fixed investment and exports remain weak</td>
<td>Dovish</td>
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<tr>
<td>Inflation</td>
<td>On a 12-month basis, overall inflation and inflation for items other than food and energy are running below 2 percent. Market-based measures of inflation remain low, survey-based measures of longer-term inflation expectations are little changed.</td>
<td>The committee judges that the current stance of monetary policy is appropriate to support the sustained expansion of economic activity, strong labour market conditions and inflation near the committee's symmetric 2 percent objective. The Committee will continue to monitor the implications of income information for the economic outlook, including global developments and muted inflation pressures, as it assess the appropriate path of the target range for the federal funds rate.</td>
<td>Neutral</td>
</tr>
<tr>
<td>Risk to the outlook</td>
<td>The committee judges that the current stance of monetary policy is appropriate to support the sustained expansion of economic activity, strong labour market conditions and inflation near the committee's symmetric 2 percent objective. The Committee will continue to monitor the implications of income information for the economic outlook, including global developments and muted inflation pressures, as it assess the appropriate path of the target range for the federal funds rate.</td>
<td>The committee judges that the current stance of monetary policy is appropriate to support the sustained expansion of economic activity, strong labour market conditions and inflation returning to the committee's symmetric 2 percent objective. The Committee will continue to monitor the implications of income information for the economic outlook, including global developments and muted inflation pressures, as it assess the appropriate path of the target range for the federal funds rate.</td>
<td>Mildly dovish</td>
</tr>
<tr>
<td>On Fed funds rate</td>
<td>Consistent with its statutory mandate, the committee seeks to foster maximum employment and price stability. The committee decided to maintain the target range for the federal funds rate at 1.5% to 1.75%.</td>
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<td>Voting</td>
<td>Voting for the monetary policy action were Jerome H. Powell, Chair; John C. Williams, Vice Chair; Michelle W. Bowman; Lael Brainard; James Bullard; Richard H. Clarida; Charles L. Evans; Randal K. Quarles; Esther L. George and Eric S. Rosengren to maintain the target range for the federal funds rate at 1.5 to 1.75 percent.</td>
<td>Voting for the monetary policy action were Jerome H. Powell, Chair; John C. Williams, Vice Chair; Michelle W. Bowman; Lael Brainard; Richard H. Clarida; Patrick Harker; Randal K. Quarles; Robert S Kaplan; Neel Kashkari and Loretta J Mester to maintain the target range for the federal funds rate at 1.5 to 1.75 percent.</td>
<td>Neutral</td>
</tr>
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Economics Research

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Treasury Desks

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<td>Corporate Bonds</td>
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<tr>
<td>Commodities Desk</td>
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